Investment Update

BNY MELLON
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Signs of Spring?

Winter is finally turning to spring here in the Northeast, and as an avid golfer I'll say it cannot come soon enough. For the past four winters, the harsh weather brought the U.S. economy to a crawl. But as the winter thawed and spring began to bloom so too did the economy, with equity markets more than fully recovering alongside the weather.

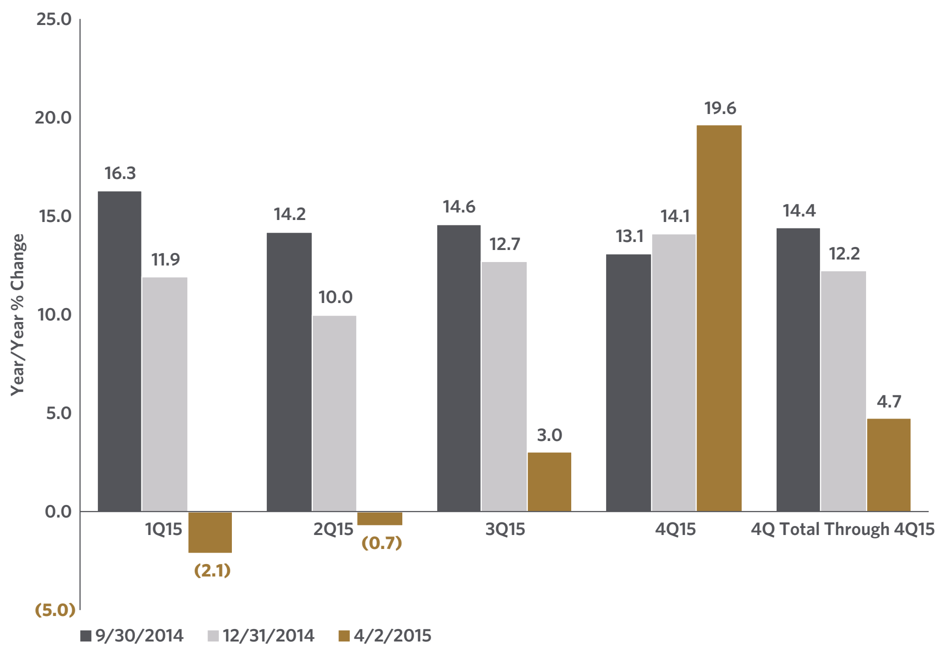
Similar patterns are playing out this year: 2015 began with yet another cold snowy winter in the Northeast, which contributed to relatively flat economic growth in the first quarter. The question remains, though, whether or not 2015 will continue to exhibit the same rebounding patterns we have seen in the past. The answer is important, as it will affect everything from stock market returns to Federal Reserve policy.

An Earnings Stall

Earnings growth drives stock market returns over time so we pay very close attention to this indicator. We began the year with a forecast for S&P 500 operating earnings per share of between \$125 and \$130. We have since lowered that to \$120 to \$125, largely due to falling oil prices and a strong dollar. The decline in oil has significantly impacted the energy sector, which makes up about 10% of the S&P 500 index, with earnings per share projected to fall 60% to 70%.

Consensus estimates on corporate earnings for the first three quarters of 2015 have been downwardly revised, with the most recent revisions dropping significantly. Analysts expect earnings to be negatively impacted in the first half of the year, with the fourth quarter bringing about an earnings recovery, as illustrated in Figure 1. One reason for analysts' confidence in a fourth quarter earnings rebound is related to the decline in oil prices, which has rebounded in recent weeks.

Figure 1—S&P 500 Consensus Operating Earnings Per Share Estimates



Source: S&P Dow Jones Indices
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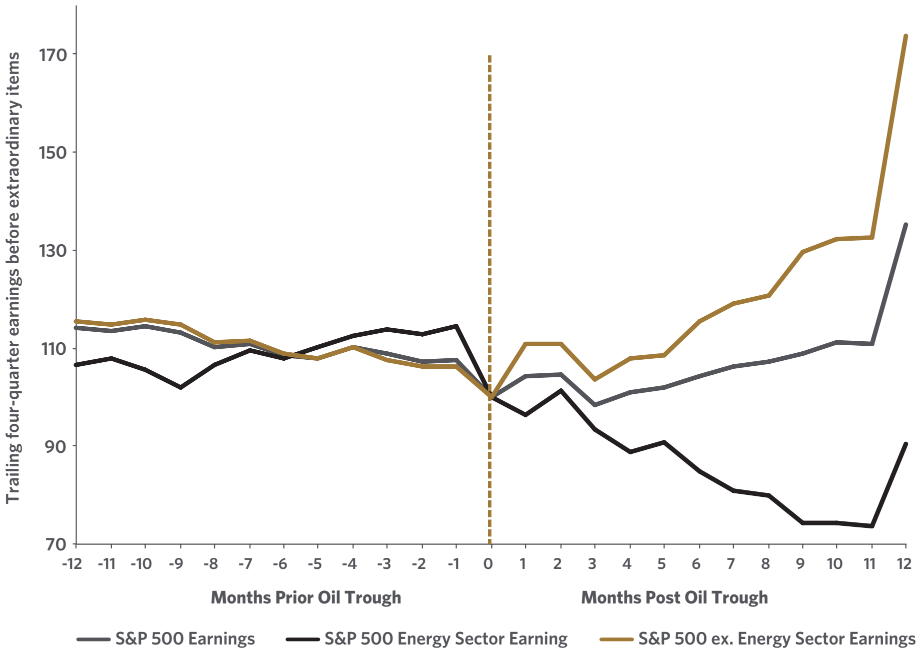
Historically, after troughs in oil prices the energy sector has struggled, while other sectors of the market have not. As shown in Figure 2, the S&P 500 typically goes on to post strong returns over the 12 months following an oil price bottom. While the market is quick to punish the energy sector as oil prices fall, it waits and rewards the rest of the market as the positive influences that come with lower prices begin to benefit consumers and corporations.

Figure 2—Earnings Around Large Oil Drop Trough Dates



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It is hard to say whether oil has in fact found a trough. But an approximate 20% recovery during the month of April in the price of oil may be an indication that at least a near-term bottom has been formed. If this indeed proves to be the case, history says (that with a slight lag) this event should bode well for equities in general.

An Upside to a Strong Dollar

Much has been written on the negative impact of a strengthening dollar on corporate earnings, but there is also a positive side to the greenback's resurgence. While the rising dollar is historically associated with slower earnings growth, it also has a positive influence on valuations. When the dollar rises year over year, price-to-earnings multiples (P/Es) actually expand, which helps to offset slower earnings growth. When the dollar falls, the opposite happens: earnings grow more rapidly, but multiples actually contract. Thus, in aggregate, the dollar seems to be more of a neutral contributor to market returns.

To date, 2015's market seems to be following this script. P/E multiples have expanded from 18.65x to 19.07x, providing most of the heavy lifting to move the market modestly higher. While we expect earnings to drive performance in the second half of 2015 as a result of strengthening global economies, it is comforting to know that multiples may continue to be of some benefit, especially if the dollar remains strong.

"It's déjà vu all over again" (Yogi Berra)

While seasonal patterns are interesting to study, they are never a substitute for robust analysis and strategic thinking about what lies ahead. Effective investment strategy requires that we look beyond the next three to six months and determine whether or not this soft patch will be just that. We expect this sub-cycle of weakness will prove transitory and economic growth will begin to bloom as consumer and business spending begin to accelerate. Spring is in the air as I finally shake the dust from my golf clubs, but markets must fully thaw from winter before they can push to fresh new highs.

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